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Islamic Banking: Home Purchase Financings Part II - Musharaka Mutanaqisa

This article continues the discussion that we began last month on *Shari'ah* compliant home financing products. The focus is on the diminishing *musharaka* (*musharaka mutanaqisa*) or diminishing partnership. This is one of the two most common home purchase financing structures. As with the *ijara*, this structure has application to other Islamic banking, finance and investment products and transactions that will be considered in future articles. Thus, the discussion includes a bit of detail that is preparatory to those forthcoming articles.

In summary, a diminishing *musharaka* home purchase financing makes use of a modern hybrid contract (the *musharaka*). It takes the form of a partnership in which one of the partners (the home buyer) promises to buy the equity interests of the other partner (the bank providing the financing) on a periodic basis until such time as the equity is completely transferred to the purchasing partner (home buyer). During the course of the purchase transaction, the bank partner leases its undivided interest in the property (the home and related land interests) to the home buyer partner. Before discussing the transaction in greater detail, it is prudent to consider a few of the relevant *musharaka* principles.

Musharaka Principles

Al-sharika is a broad term based on its meaning of "sharing". In the commercial and financial realm, the term encompasses various joint ownership arrangements and partnerships for profit effected by mutual contract. *Sharikat al-aqd* is a partnership effected by mutual contract (a 'joint commercial enterprise'), and there are various subdivisions of this type of partnership arrangement.¹ One such primary subdivision is comprised of partnerships in which all partners invest capital in a commercial enterprise (*sharikat al-amwaa*), and it is a secondary subdivision of this primary subdivision (*sharikat alinan*) that is most frequently referred to when the term "*musharaka*" is used.²

In summary, and as a broad definitional statement, a *musharaka* is a type of *fiqh*-nominate partnership in which each of the partners may contribute capital and in which, subject to the terms of the partnership (*musharaka*) agreement, each of the partners may participate in management. If all partners participate in the management of the *musharaka*, each partner is treated as the agent of all other partners. As a general statement, and subject to relevant *Shari'ah* principles, profits are allocated in accordance with the *musharaka* agreement and losses are allocated in accordance with the ratios of capital contributions.³

Musharaka agreements are quite similar to Western partnership agreements in scope and coverage. In the context of a home purchase financing, the *musharaka* agreement may be expanded to include the full range of provisions that are found in documents governing conventional home purchase financings. Thus, for example, *musharaka* agreements may specify the term of the partnership, the purpose of the *musharaka*, limitations on the powers or permissible methods of dealing of each of the partners, the terms of dealing that are required and those that are permitted, circumstances in which the various partners will have consent rights, and the full panoply of representations, warranties, covenants, insurance requirements, events of default, remedies and termination rights. In some structures, some of the foregoing concepts (such as covenants, events of default and remedies) are included in the lease (*ijara*) of the bank partner's undivided interest in the property to the home buyer partner.

There are significant differences between the *madhab* regarding the rules applicable to capital contributions, especially as to the permissibility and effect of in-kind contributions.⁴ However, the schools all seem to agree that capital, once contributed, is the property of the *musharaka* (rather than any individual partner) and inures to the benefit of all partners. Capital must be specified at the inception of the *musharaka*, including as to the total

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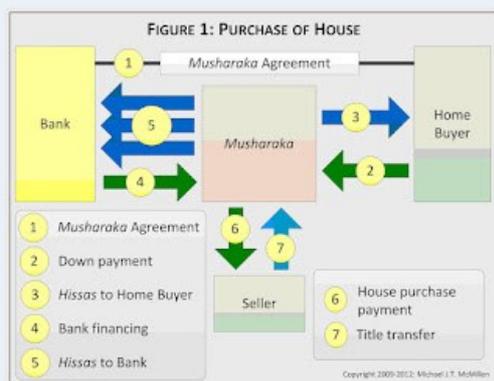
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amount and the share of each partner. The capital contributions of the different partners need not be equal. In accordance with historical requirements, there is a pronounced preference for cash capital contributions. Absent agreement to the contrary in the *musharaka* agreement, the liability of each partner is unlimited. It is not permissible for one partner to assume liability for the capital of another partner, whether by way of guarantee or otherwise. There is an exception to this last rule in limited circumstances of misconduct, default, breach of contract, and negligence.⁵

A partner in a *musharaka* may purchase the shares or interests (*hissas*) of the other partner(s) in the *musharaka*. Any such purchase may be of the whole or it may be partial and incremental. The AAOIFI Partnership Standard allows any partner to purchase the assets of the *musharaka* at their market value or at a price agreed at the date of the purchase of the assets.⁶ This has obvious implications for *hissa* purchases as well. However, it is not permissible to agree to buy the assets on the basis of face value. Many scholars are of the opinion that the provisions relating to the purchase of *hissas* should be in a document separate and apart from the *musharaka* agreement. Others allow the provision to be in the *musharaka* agreement. Usually, these provisions allow a partner to buy another partner's *hissas* within an agreed period for a fixed price.

Diminishing *Musharaka* Home Financings

The funding, financing and purchase of the home (including land or interests in land) are illustrated in FIGURE 1: PURCHASE OF HOUSE. FIGURE 2: LEASING AND OWNERSHIP illustrates the status of ownership and leasing prior to and during the course of the *Hissa* purchase transactions that are used to effect repayment of the Bank financing.



In the diminishing *musharaka* structure, the Home Buyer identifies a property to be purchased and negotiates a home purchase agreement with the third-party Seller. That home purchase agreement (not illustrated in Figure 1) must be acceptable to the Bank that will provide the home purchase financing.

The Bank and the Home Buyer then enter into a musharaka agreement (step 1 in each of Figure 1 and Figure 2) and form a partnership (the *Musharaka*) that will acquire the property. The *Musharaka* Agreement governs the acquisition, financing and use of the property and provides for the purchase of the Bank's interests in the *Musharaka* by the Home Buyer over time. The Home Buyer contributes the down payment for the home as a capital contribution into the *Musharaka* (step 2 in Figure 1) and receives *Hissas*, or equity interests, in the *Musharaka* (step 3 in Figure 1 and step 4 in Figure 2). The Bank providing the financing contributes the remainder of the purchase price of the property as its capital contribution into the *Musharaka* (step 4 in Figure 1) and it also receives *Hissas* (step 5 in Figure 1 and step 6 in Figure 2). The *Musharaka* then purchases the property from the Seller (step 6 in Figure 1) and takes title to the property (step 7 in Figure 1).⁷

After the *Musharaka* has obtained title to the property, the Bank leases its undivided right, title and interest in, to and under the property to the Home Buyer. This is illustrated as step 8 in Figure 2.

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[Dima Tayara, Associate](#)
 Curtis, Mallet-Prevost, Colt & Mosle LLP
 Qurum Plaza
 108 Al Wallaj Street
 P.O. Box 1803; PC 114
 Muscat, Sultanate of Oman
 Tel: +968 24 564 495
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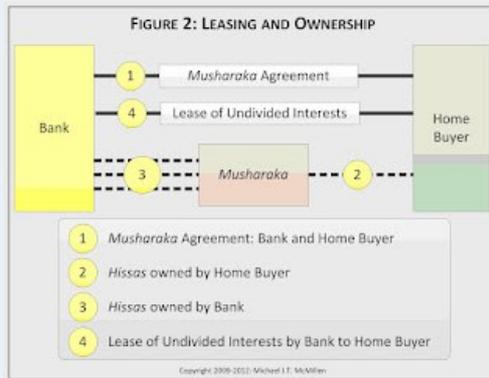
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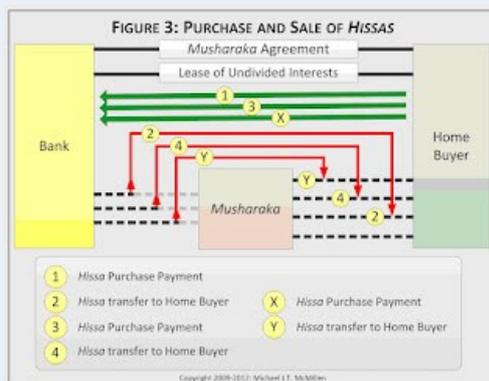
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The leasing arrangements allow the Home Buyer to occupy and use the property. The leasing arrangements may also include a managing agent arrangement (as a separate document) pursuant to which the Home Buyer agrees to maintain the property and maintain casualty insurance on the property as these are obligations that may not be passed to the tenant in a *Shari'ah*-compliant lease.⁸ The leasing arrangements may also provide for rents that, combined with the *hissa* purchase payments, ensure the adequacy of the amortization schedules desired by the Bank, rendering considerable financial flexibility to the structure.

The financing provided by the Bank is paid and retired through the purchase and sale of the Bank's *Hissas*, which are incrementally and periodically acquired by the Home Buyer from the Bank. This sequence of transactions is illustrated in FIGURE 3: PURCHASE AND SALE OF *HISSAS*. In Figure 3 (and the other Figures in this article), the undertaking of the Home Buyer to purchase the *Hissas* of the Bank is not separately shown; it is assumed to be included in the *Musharaka* Agreement.



The Home Buyer makes periodic *Hissa* purchase payments to the Bank. These payments are illustrated as steps 1, 3 and 5 in Figure 3. Corresponding to each such payment, the Bank transfers *Hissas* to the Home Buyer. These transfers are illustrated as steps 2, 4 and 6, respectively, in Figure 3. At such time as all of the *Hissas* are owned by the Home Buyer, the *Musharaka* is terminated and the property is owned solely by the Home Buyer.⁹

The amounts of the *Hissa* purchase payments are determined in accordance with the amortization schedule used by the specific Bank providing the financing. Each payment includes both a profit component and a principal component, with the relative amount of each component varying over time in much the same manner as the relative amounts of interest and principal on a conventional interest-bearing mortgage loan vary over time. Frequently, the amortization schedule is essentially identical to that on a conventional 30-year or 15-year mortgage financing. However, the structure of the amortization schedule will be determined in discussions with the *Shari'ah* scholars that supervise the home purchase finance program for the Bank. Different scholars have different views of the permissible pricing for purchases of the *Hissas* and these pricing considerations will influence the exact amortization schedules. It is also to be noted that the lease payments provide additional flexibility with respect to overall pricing of the transaction and the sum of the lease payments and the *Hissa* purchase payments, taken together, will often equal the combined profit and principal amortization that is desired by the Bank.

There are two variations in the termination provisions of the diminishing *musharaka* structure. One variation, and the less common variation, involves termination without an undertaking to purchase (*wa'd*). In this variation, the exercise of remedies in connection with an event of default entails selling the property in the market and sharing the proceeds between the Bank and the Home Buyer in accordance with their respective capital contributions at the time of the sale.

The more common structural variation involves the use of an undertaking to purchase (a *wa'd*) pursuant to which the Home Buyer agrees to purchase all of the *Hissas* of the Bank at the time of the event of default and demand by the Bank. It is the mechanism by which the Bank accelerates and

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unwinds the structure prior to the scheduled final maturity. The Home Buyer is obligated to purchase all Bank *Hissas* immediately at a fixed price (equal to the outstanding principal plus accrued profit plus fees, costs and expenses). Typically, there is full recourse to the Home Buyer in respect of the payment of these amounts. If the Home Buyer is not able to make payment in full for all of the Bank's *Hissas*, the property will be sold at an auction and the proceeds are applied to make payment in full to the Bank, including in respect of its fees, costs and expenses in exercising remedies, and the excess, if any, is distributed to the Home Buyer).

Future articles

The next article will continue the discussion of *Shari'ah*-compliant home purchase financing products. It will take up *murababaha* structures and then move to *bay' bithaman ajil and istisna'a* – parallel *istisna'a* structures.

As the Sultanate of Oman prepares to roll out its new legal and regulatory framework for Islamic banking in the coming months, we will be covering Islamic banking in the Client Alert as it is an important and growing field. This article is the third in a series by Curtis partner Michael J.T. McMillen, an Islamic finance specialist based in our New York office who provides support to our Islamic banking practice in Oman and throughout the Middle East region.

1. See, for example, Sharia Standard No. (12), (Sharika (Musharaka) and Modern Corporations) (the "AAOIFI Partnership Standard") in SHARI'A STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS 1432 H - 2010, Accounting and Auditing Organization for Islamic Financial Institutions (1432 H – 2010). The AAOIFI Partnership Standard applies to all forms of traditional fiqh-nominate partnerships that operate on the basis of the contractual partnership (sharikat al-aqd), except as expressly set forth in the AAOIFI Partnership Standard), and to diminishing musharaka (musharaka mutanaqisa) structures
2. Occasionally, the term musharaka is used to refer to sharikat ul-amal, a type of partnership in which the partners contribute service
3. This article addresses personal home financings, and not commercial ventures involving subletting or the generation of profits from the operation of the acquired asset(s). Thus, profit and loss principles are not discussed.
4. This article does not address complexities of in-kind contributions because the current scope is limited to personal home financings.
5. See, e.g., the AAOIFI Partnership Standard, supra note 1, at § 3/1/4/1.
6. See, e.g., the AAOIFI Partnership Standard, supra note 1, at § 3/1/6/2.
7. In some jurisdictions, the Home Buyer takes title to the property, acting as an agent for and on behalf of the Musharaka. This variation may be used in jurisdictions that impose a transfer or similar tax on the movement, to the Home Buyer, of title to the property upon dissolution of the Musharaka (as discussed below).
8. In some transactions, these obligations are addressed in the *musharaka* agreement.
9. Under the laws of most jurisdictions, a partnership must have greater than one partner (and cannot exist if there is only one partner). In those jurisdictions, the partnership is automatically dissolved upon the sale of the last of the Bank's *Hissas* to the Home Buyer, whereupon the Home Buyer becomes the sole and direct owner of the property.

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